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Financial Test Discussion Paper

Financial assurance requirements were established to ensure the availability of sufficient financial resources for use by regulatory agencies to complete closure, postclosure, and corrective action activities without the use of public funding when hazardous waste facility owner/operators fail to perform the required activities. In addition, financial assurance requirements also require facility owner/operators to provide liability coverage for damages to third parties resulting from sudden and/or non-sudden releases from facilities.

The financial assurance regulations provide for a number of different mechanisms for use by facility owner/operators. These mechanisms include trust funds, letters of credit, payment and performance bonds, insurance, and the financial test/corporate guarantee.

The financial test/corporate guarantee¹, is one of the most commonly used financial assurance mechanisms in California. Facility owner/operators in California use the financial test to provide assurance for approximately \$955,000,000 in closure and/or postclosure costs, sudden and/or non-sudden third party liability coverage, and corrective action costs.

The financial test assumes a facility owner/operator can satisfy its financial responsibility (FR) obligations through the strength of its financial condition and isn't required to use any of the other mechanisms specified in the FR regulations. In order to use the financial test, the facility owner/operator must demonstrate that it meets certain financial worth and financial ratio requirements using information from audited financial statements.

These requirements include:

- Tangible net worth of at least \$10 million;
- Net working capital and tangible net worth each at least six times current closure cost estimate, postclosure cost estimate, third-party liability coverage and corrective action cost estimate;
- Two of the following three ratios
 - Total liabilities to net worth less than 2.0
 - Sum of net income plus depreciation, depletion, and amortization to total liabilities greater than 0.1
 - Current assets to current liabilities greater than 1.5

¹ For purpose of this discussion the term “financial test” will be used as a generic term to refer to both the financial test and the corporate guarantee. The difference between the two is a facility owner/operator's audited financial statements are used to meet the financial test requirements. With the corporate guarantee, a related corporation's financial statements are used to meet the requirements and the related corporation guarantees to perform the obligations.

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- Assets located in the United States amounting to at least 90 percent of total assets or at least six times the sum of the current closure cost estimate, postclosure cost estimate, third-party liability coverage and corrective action cost estimate.

Certain of the requirements can be satisfied if the owner/operator has a current Standard and Poor's rating of AAA, AA, A, or BBB or a Moody's rating of Aaa, Aa, A, or Baa for its most recent bond issuance.

The financial test places regulatory agencies at a higher level of risk of having to use public funds for performing closure, postclosure, or corrective action activities in comparison to the other available financial mechanisms. With the exception of a captive insurance policy, all of the other mechanisms involve an independent third party separate from either the owner/operator or the regulatory agency, and the third party either administers a trust fund or has a contractual obligation to provide the Department of Toxic Substances Control (DTSC) with resources that will allow the performance of the necessary work.

For example, the trust fund is a legal entity separate from the owner/operator that is governed by a trust agreement and administered by a trustee. The trust's assets are shielded from a bankruptcy action filed by the owner/operator. The model trust agreement mandated by financial assurance regulations provides for withdrawals from the trust account only under specific circumstances and only with permission of the regulatory agency.

Similar requirements are in place for the other allowable mechanisms that provide for the continuation of the availability of financial resources independent of the financial condition of the owner/operator. If the independent third party fails to meet financial assurance requirements in some way, then regulations require the owner/operator to replace the financial mechanism within a specified period of time. Accordingly, for all the mechanisms except the financial test, both the facility owner/operator and the independent third party must fail at the same time in order to present a risk of having use to public funds to complete the required activities.

The same is not the case with the financial test. All that has to happen is to have the facility owner/operator not meet its environmental obligations and there is no fall-back mechanism to provide financial resources. If the facility owner/operator files bankruptcy, the regulatory agency is at the whim of a federal bankruptcy court which tends to favor payment of unsecured trade creditors over less understood environmental obligations. The regulatory agency is then forced to use public funds.

Even if the facility owner/operator doesn't file for bankruptcy, the regulatory agency is forced to expend significant technical and legal resources over a long period of time attempting to force the facility owner/operator to meet its

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obligations. In the interim, it is likely public funds would have to be used for required activities.

California regulations allow facilities which handle only non-RCRA hazardous waste to propose the use of an alternate mechanism to meet its financial assurance requirements. The regulations require DTSC to evaluate the equivalency of the proposed alternative mechanism with allowed mechanisms principally in terms of the certainty of the availability of funds for the required activities and the amount of funds that will be made available.

Assume for purposes of discussion that the financial test was not an allowable mechanism and the owner/operators of a non-RCRA facility proposed the use of an alternate mechanism similar to the financial test. Using the regulatory standard of equivalency to existing mechanisms in terms of certainty of amount and availability of funds, DTSC likely would not approve the use of the proposed mechanism as it provides absolutely no certainty as to the amount or the availability of funds.

Another factor in the level of risk is the significant role financial statements play in the financial test. Audited financial statements define a company's historical financial condition at a point in time and aren't an indicator of a company's future financial condition. However, the future financial condition of a facility owner/operator is important to environmental agencies because closure, corrective action and especially postclosure costs can occur over an extended period of time.

The reliability of the audited financial statements is also an important factor in the level of risk posed to a regulatory agency inherent in the use of the financial test. As indicated by the corporate accounting scandals occurring over the last few years, the roles played by corporate management, financial regulatory agencies, independent accounting firms, and stock analysts all have a significant impact on the reliability of financial statements. The Enron, Tyco, WorldCom, Adelphia, and Global Crossing accounting scandals were the result of conscious decisions by high level corporate management to maximize financial results and were possible because independent auditors and regulatory agencies weren't meeting their responsibilities.

In response to these scandals, the Sarbanes-Oxley Act was signed into law on June 30, 2002. The Sarbanes-Oxley Act's major provisions include:

- Certification of financial reports by CEOs and CFOs;
- Ban on personal loans to any Executive Officer or Director;
- Accelerated reporting of trades by insiders;
- Prohibition on insider trades during pension fund blackout periods;
- Public reporting of CEO and CFO compensation and profits;

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- Auditor independence, including outright bans on certain types of work and pre-certification by the company's Audit Committee and all other non-audit work;
- Criminal and civil penalties for securities violations;
- An obligation for US companies to have an internal audit function, which will need to be certified by external auditors;
- Significantly longer jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements;
- Prohibition on audit firms providing extra "value-added" services to their clients including actuarial services, legal and extra services (such as consulting) unrelated to their audit work; and,
- A requirement that publicly traded companies furnish independent annual audit reports on the existence and condition (i.e., reliability) of internal controls as they relate to financial reporting.

The impact of these new requirements on the reliability of financial statements remains to be seen. There have been frequent comments concerning the cost to business of complying with the new standards (primarily the internal control requirements). Comments that the costs are more than estimated may lead to relaxing the internal control standards. In addition, problems with financial statements continue to occur. American International Group, Inc., which describes itself as the leading international insurance organization and the largest underwriter of commercial and industrial insurance in the United States, was recently forced to reduce its shareholder's equity by \$2.7 billion as a result of accounting misstatements. The Attorney General of the State of New York recently filed a lawsuit alleging that AIG former top management engaged in numerous fraudulent business transactions that exaggerated the strength of the company's core underwriting business to prop up its stock price.

The potential impact of the use of the financial test on DTSC is taking the lead on closure, postclosure, or corrective action activities for a bankrupt facility which used the financial test. This situation would put a burden on DTSC's limited technical staff and financial resources from its special funds. It would also be difficult to get funding from the general fund given the State's current financial condition.

At first glance, simply leaving the financial test requirements as they now exist would make sense given there have been no instances where DTSC had to perform closure, postclosure, or corrective action activities where a facility owner/operator using the financial test has failed. However, certain adjustments need to be made to some of the financial test requirements to adjust for the passage of time. For example, the requirement for a tangible net worth of at least \$10 million hasn't changed since the financial assurance requirements were put into place in April 1982. Since that time, inflation has resulted in \$10 million in 1983 dollars being equivalent to over \$17.5 million today. This results in firms qualifying to use the financial test today which would not have qualified in 1982.

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Another alternative would be to eliminate the financial test as an approved financial assurance mechanism, which is what the States of New Hampshire and Arkansas have done. The elimination of the financial test would decrease the risk of having DTSC spend State funds significantly. The elimination of the financial test in California would also “level the playing field” in that all hazardous waste facilities would have to use one of the remaining mechanisms which involve an independent third-party. Facility owner/operators who currently use the financial test should have no problems affording the cost of one of the other allowable mechanisms.

At some point, a corporation has such a strong financial condition there truly can be no question that it can meet its environmental liabilities in California. The problem is with how to define that point. So rather than eliminating the financial test, one approach is to make changes to the requirements to reduce the risk of DTSC having to use State funds to perform closure, postclosure, or corrective action activities. Such changes might include:

- Requiring Facility Owner/Operators to Have an Altman’s Z Score of 3.0 or Higher – As previously mentioned, financial statements present historical income and expense information and define a company’s financial condition as of a point in time in the past. Financial statements by themselves do not provide any guarantee of a company’s future financial condition, which can be some what problematic for assuring the payment of environmental obligations in short term and the long term.

Although facility owner/operators are required to requalify for the use of the financial test on an annual basis, the annual submittal of financial information does not require sufficient lead time so that the facility owner/operator would be able to obtain one of the other mechanisms.

One tool which can provide a longer lead time in the identification of potential problems is a bankruptcy prediction model called Altman’s Z Score. The model predicts the solvency of a company by using a score based upon five different financial ratios with each ratio being assigned a different weight. If the score is 3.0 or higher, then insolvency within the next two years is not likely. A score between 1.8 and 2.9 indicates a medium to high probability of insolvency within the next two years, and a score of less than 1.8 indicates a very high probability of insolvency in the next two years. If a facility owner/operator doesn’t have a Z score of at least 3.0, then they must use one of the other financial mechanisms rather than the financial test.

- Increase the Tangible Net Worth Requirement From the Current Requirement of \$10 Million to \$20 Million – The tangible net worth requirement was set at \$10 million when the financial assurance regulations were added in April 1982, but it has remained unchanged

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since then. The US EPA Inspector General's report entitled *RCRA Financial Assurance For Closure and Post-Closure* (Report #2001-P-007 dated March 30, 2001) states the following with regard to the financial test:

“Although there is some risk of failure for firms which pass the corporate financial test, the test is meant to reduce the risk to a low level by screening out firms with higher risks of failure. Since the risk of bankruptcy increases when a firm's net worth decreases, firms are required to have a minimum of \$10 million in tangible net worth to pass the corporate financial test. The Agency has determined that firms with less than \$10 million in tangible net worth went bankrupt four times more frequently than firms with tangible net worth greater than \$10 million.” (*emphasis added*)

Due to the effects of monetary inflation, the current \$10 million tangible net worth requirement offers far less protection against the risk of bankruptcy of firms using the financial test than it once did when the financial assurance requirements were implemented 23 years ago. According to the Gross Domestic Product Implicit Price Deflator, the inflation rate between April 1982 and the first quarter of 2005 has been 76.4%.

The significance of the inflation rate is that \$10,000,000 in today's dollars is equivalent to only \$5,668,934 in 1982 dollars due to the loss of purchasing power in the intervening 23 years. Thus, not adjusting the \$10 million tangible net worth requirement to reflect inflation has substantially increased the risk of bankruptcy as indicated in the US EPA Inspector General's report. The requirement needs to be increased to \$17,640,000 to reflect the 76.4% inflation rate. Increasing the requirement to \$20 million lessens the risk of bankruptcy even more.

- Eliminate Assets Used as Security For Other Liabilities From the Tangible Net Worth Calculation – If a facility owner/operator using the financial test files for bankruptcy, the regulatory agency will have to file a claim with the bankruptcy court in order to attempt to recover costs paid by public funds. However, any assets which are used to secure debt will be used to repay the secured debt and may not be available for meeting its environmental obligations for which the financial test was used.

For example, loans for real property are normally secured by the property itself. Lines of credit are usually secured by inventories, accounts receivable or other assets to the extent such assets are not being used to secure other debt. In the bankruptcy process, secured assets are used to pay off the secured debt first. If there are any assets remaining after full payment of the secured debt, those assets are available for payment to unsecured creditors.

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The tangible net worth calculation is simply subtracting non-tangible assets such as goodwill and intellectual property amounts from total assets and then subtracting total liabilities from that amount. One way of further reducing risk to DTSC would be to also subtract assets used as security for debt, and which aren't available for use to meet environmental obligations, from total assets as part of the tangible net worth calculation.

- The Amounts Included on Line 1 of DTSC's Financial Test Forms Should Include Obligations For Any Hazardous Waste, Solid Waste, or Radioactive Waste Facility for Which the Financial Test is Being Used Regardless of Where Such Facilities Are Located – It is not uncommon for a facility owner/operator to have more than one hazardous waste facility in California and to have facilities located in other states as well. Nor is it uncommon for an owner/operator to own other types of related facilities, such as solid waste landfills, which also have financial assurance requirements. Hazardous waste facility owner/operators using the financial test in California should be required to include the costs and third-party liability amounts for all types of facilities, regardless of where they are located, to the extent the owner/operator is using the financial test to guarantee those obligations. This will protect DTSC from the risk of a facility owner/operator using a number of individual financial tests when it doesn't have the financial capability to meet a financial test for its environmental obligations as a whole.